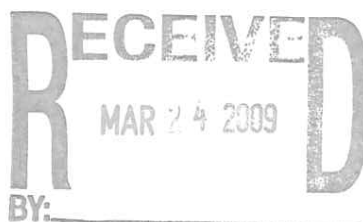


RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Single Audit Reports

June 30, 2008

DATE RECEIVED:



AUDIT REVIEW #(s) 04530

Assigned To: Armstrong

Date Reviewed: 4-7-09

Reviewer's Initials: RA

Date Review(s) Completed: 4-7-09

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

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KPMG LLP
Suite 1500
750 B Street
San Diego, CA 92101-8191

Independent Auditors' Report

The Board of Trustees
Rady Children's Hospital and Health Center:

We have audited the accompanying consolidated balance sheet of Rady Children's Hospital and Health Center and subsidiaries (the Company) as of June 30, 2008, and the related consolidated statements of operations, changes in net assets and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The accompanying consolidated financial statements of the Company as of June 30, 2007, were audited by other auditors whose report, dated October 5, 2007, on those statements was unqualified and included an explanatory paragraph that described the Company's adoption of Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2008 consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of June 30, 2008, and the results of their operations, their changes in net assets and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 18, 2008, on our consideration of the Company's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

KPMG LLP

September 18, 2008, except
for note 13(b), which is as
of November 20, 2008.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Consolidated Balance Sheets

June 30, 2008 and 2007

(Dollars in thousands)

Assets	2008	2007
Current assets:		
Cash and cash equivalents	\$ 22,951	680
Collateral received under securities lending program	33,918	22,233
Investments	316,296	314,229
Securities lent under securities lending program	32,971	21,781
Patient accounts receivable, net of allowance for doubtful accounts of \$29,525 and \$26,179 at June 30, 2008 and 2007, respectively	50,623	51,348
Other receivables	19,083	22,445
Assets limited as to use – required for current liabilities	2,543	4,861
Inventory	6,509	5,718
Other current assets	4,297	4,401
Total current assets	489,191	447,696
Assets limited as to use	161,952	63,091
Less assets required for current liabilities	(2,543)	(4,861)
	159,409	58,230
Property and equipment, net	199,455	155,390
Interest rate swaps	—	1,887
Other long-term assets	40,220	44,119
Total	\$ 888,275	707,322
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued expenses	\$ 42,624	34,258
Accrued payroll and related benefits	28,546	28,956
Payable under securities lending program	33,918	22,233
Current portion of long-term debt	2,680	3,125
Advances of State funding for property and equipment	—	3,309
Deferred revenue	2,432	2,063
Total current liabilities	110,200	93,944
Long-term debt, net of current portion	312,048	190,300
Interest rate swaps	7,913	—
Other long-term liabilities	37,418	25,782
Payable to beneficiaries under deferred giving arrangements	1,548	1,784
Total liabilities	469,127	311,810
Commitments and contingencies		
Net assets:		
Unrestricted	359,799	330,019
Temporarily restricted	51,256	58,260
Permanently restricted	8,093	7,233
Total net assets	419,148	395,512
Total	\$ 888,275	707,322

See accompanying notes to consolidated financial statements.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Consolidated Statements of Operations

Years ended June 30, 2008 and 2007

(Dollars in thousands)

	<u>2008</u>	<u>2007</u>
Operating revenues:		
Net patient revenue	\$ 367,322	325,285
Premium revenue	33,609	34,220
Grants and contracts	23,058	20,464
Other government revenue	30,733	31,439
Physician management services revenue	27,299	23,123
Other revenue	21,044	19,616
Net assets released from restrictions used for operations	11,440	8,077
Total	<u>514,505</u>	<u>462,224</u>
Operating expenses:		
Salaries and wages	174,877	160,483
Employee benefits	63,832	56,073
Supplies	73,826	64,823
Professional fees	41,952	38,774
Purchased services	51,965	50,106
Provision for bad debts	14,692	16,955
Insurance	5,598	7,837
Bond insurance impairment	5,827	—
Other	21,918	22,645
Depreciation	13,214	12,343
Interest	5,467	4,721
Loss on extinguishment of debt	—	2,772
Total	<u>473,168</u>	<u>437,532</u>
Operating income	41,337	24,692
Nonoperating income (expenses):		
Contributions	6,982	12,115
Fundraising expenses	(4,908)	(3,954)
Change in fair value of interest rate swaps	(9,800)	1,887
Interest, dividends, and net realized gains on investments	5,436	21,158
Reclassification of investment portfolio to trading	3,234	—
Excess of revenues over expenses	<u>\$ 42,281</u>	<u>55,898</u>

See accompanying notes to consolidated financial statements.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Consolidated Statements of Changes in Net Assets

Years ended June 30, 2008 and 2007

(Dollars in thousands)

	<u>2008</u>	<u>2007</u>
Unrestricted net assets:		
Excess of revenues over expenses	\$ 42,281	55,898
Net unrealized gains (losses) on investments	(22,298)	11,939
Reclassification of investment portfolio to trading	(3,234)	—
Third party funding for property and equipment	18,955	1,415
Net assets released from restrictions used for purchase of property and equipment	3,239	1,512
Change in unrecognized net defined benefit plan cost not yet recognized in net periodic benefit cost	(9,163)	—
Effect of adoption of recognition provisions of SFAS No. 158	—	(6,771)
Increase in unrestricted net assets	<u>29,780</u>	<u>63,993</u>
Temporarily restricted net assets:		
Contributions	7,925	8,787
Change in value of split-interest agreements	151	1,135
Investment income (loss)	(401)	1,224
Net assets released from restrictions	(14,679)	(9,589)
Increase (decrease) in temporarily restricted net assets	<u>(7,004)</u>	<u>1,557</u>
Permanently restricted net assets:		
Contributions	860	746
Increase in permanently restricted net assets	<u>860</u>	<u>746</u>
Total increase in net assets	23,636	66,296
Net assets at beginning of year	<u>395,512</u>	<u>329,216</u>
Net assets at end of year	<u><u>\$ 419,148</u></u>	<u><u>395,512</u></u>

See accompanying notes to consolidated financial statements.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Consolidated Statements of Cash Flows

Years ended June 30, 2008 and 2007

(Dollars in thousands)

	2008	2007
Cash flows from operating activities:		
Increase in net assets	\$ 23,636	66,296
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	13,043	12,632
Provision for bad debts	14,692	16,955
Net realized and unrealized (gains) losses on investments	19,476	(26,145)
Change in fair value of interest rate swap	9,800	(1,887)
Bond insurance impairment	5,827	—
Loss on extinguishment of debt, noncash portion	—	1,161
Contributions restricted to property and endowments	(4,662)	(2,242)
Changes in assets and liabilities:		
Patient accounts receivable	(13,967)	(21,051)
Other receivables	3,362	2,146
Inventory	(791)	(678)
Other current assets	104	2,868
Other long-term assets	1,358	5,286
Accounts payable and accrued expenses	7,400	2,592
Accrued payroll and related benefits	(410)	7,379
Advances of State funding for property and equipment	(3,309)	3,309
Deferred revenue	369	1,195
Other long-term liabilities	11,636	(214)
Payable to beneficiaries under deferred giving arrangements	(236)	(1)
Net cash provided by operating activities	<u>87,328</u>	<u>69,601</u>
Cash flows from investing activities:		
Purchases of investments	(261,992)	(175,128)
Proceeds from sales and maturities of investments	229,259	89,886
Acquisition of property and equipment	(56,313)	(32,614)
Increase in assets limited as to use	(98,861)	(54,622)
Net cash used in investing activities	<u>(187,907)</u>	<u>(172,478)</u>
Cash flows from financing activities:		
Cash received for contributions restricted to property and endowments	4,662	2,242
Payment of long-term debt issuance costs	(3,286)	(6,926)
Net proceeds from issuing long-term debt	124,599	186,623
Repayment of long-term debt	(3,125)	(94,127)
Net cash provided by financing activities	<u>122,850</u>	<u>87,812</u>
Net increase (decrease) in cash and cash equivalents	22,271	(15,065)
Cash and cash equivalents, beginning of year	680	15,745
Cash and cash equivalents, end of year	<u>\$ 22,951</u>	<u>680</u>
Supplemental disclosures of cash flow information:		
Interest paid during the year, net of amounts capitalized	\$ 5,393	5,088
Change in collateral received under securities lending program	11,685	6,582
Change in payable under securities lending program	(11,685)	(6,582)
Property additions recorded in accounts payable	2,361	1,394

See accompanying notes to consolidated financial statements.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

(1) Organization

Rady Children's Hospital and Health Center (RCHHC) is the sole statutory member of the following not-for-profit, tax-exempt entities:

- Rady Children's Hospital – San Diego (RCHSD)
- Rady Children's Hospital Foundation – San Diego (Foundation)
- Rady Children's Hospital Research Center (RCHRC) and
- Rady Children's Health Services – San Diego (RCHSSD)

In addition, RCHHC owns the following for-profit subsidiaries:

- Children's Hospital Integrated Risk Protective Limited (CHIRPL) and
- Rady Children's Physician Management Services, Inc. (RCPMS)

All of the above entities are referred to in these financial statements as the "affiliates" of RCHHC. The accompanying consolidated financial statements present the financial position, results of operations, changes in net assets, and cash flows of RCHHC and its affiliates on a consolidated basis. All intercompany transactions have been eliminated.

A brief description of each of the entities follows:

- *Rady Children's Hospital and Health Center* was formed to acquire, establish, maintain, conduct, operate, raise funds for, and otherwise support, directly or indirectly through its affiliates, facilities, and programs for the benefit of children and adults with diseases, disorders, and other health problems of pediatric origin, including providing resources for charity care, research, and education. In addition, RCHHC solicits and receives grants and donations to be used to promote and advance the welfare and activities of its affiliates.
- *Rady Children's Hospital – San Diego* provides comprehensive inpatient acute and intensive care pediatric services and also provides comprehensive outpatient, home health, long-term convalescent hospital, and child protection and developmental services. RCHSD is the sole Level I Pediatric Trauma Center in San Diego County.
- *Rady Children's Hospital Foundation – San Diego* was formed to advance, promote, raise funds for, and otherwise support the activities of RCHHC and its affiliates.
- *Rady Children's Hospital Research Center* engages in scientific medical research and conducts clinical research in diseases and disorders affecting children and adolescents, and is primarily funded by grants and contracts from government and private agencies.
- *Rady Children's Health Services – San Diego* was formed to aid and assist RCHHC in carrying out the charitable purposes and programs of RCHHC and its affiliates.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

- *Children's Hospital Integrated Risk Protective Limited* is a holding company for Children's Hospital Insurance Limited (CHIL). CHIL is an offshore captive insurance company domiciled in Bermuda, which underwrites the professional liability, general liability and employment practices liability insurance risk exposures of RCHHC and its affiliates.
- *Rady Children's Physician Management Services, Inc.* operates a management services organization that provides facilities, personnel, and services to pediatric medical groups for the operation of medical practices.

(2) Summary of Significant Accounting Policies

(a) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(b) Cash and Cash Equivalents

For purposes of the consolidated financial statements, RCHHC considers all highly liquid investments, other than those included in its investment portfolio, which are purchased with a maturity of three months or less from the date of purchase, to be cash and cash equivalents.

(c) Investments

On June 30, 2008, RCHHC changed the classification of its investments in debt and equity securities with readily determinable fair values to trading. Prior to June 30, 2008, these investments had been considered available-for-sale.

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the consolidated statements of financial position. Alternative investments represent ownership interests in limited partnerships and limited liability companies that are not readily marketable. Alternative investments are carried at fair values reported by the investment managers. RCHHC reviews and evaluates the values provided by the managers and agrees with the valuation methods and assumptions used in determining the fair value of these alternative investments. Because alternative investments are not readily marketable, their estimated value is subject to uncertainty and may differ from the value that would have been used had a ready market for such investments existed. Such differences could be material.

Investment income or loss (including interest and dividends and realized gains and losses on investments) is included as nonoperating gains (losses), within excess of revenue over expenses, unless the income or loss is restricted by donor or law, in which case the investment income or loss is recorded directly to temporarily restricted net assets. Prior to June 30, 2008, unrealized gains and losses on investments are excluded from excess of revenue over expenses. After the designation of

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

investment securities as trading on June 30, 2008, unrealized gains and losses are included in nonoperating income (expenses) within the excess of revenues over expenses.

(d) Securities Lending Program

RCHHC participates in securities lending transactions with its custodian, whereby RCHHC lends a portion of its investments to various brokers in exchange for collateral for the securities loaned, usually on a short-term basis. Collateral provided by brokers is maintained at levels of at least 100% of the fair value of the securities on loan and is adjusted for market fluctuations. RCHHC maintains effective control of the loaned securities through its custodian during the term of the arrangement in that they may be recalled at any time. Under the terms of the agreement, the borrower must return the same, or substantially the same, investments that were borrowed. The market value of collateral held for loaned securities is reported as collateral received under securities lending program, and a corresponding obligation is reported for repayment of such collateral upon settlement of the lending transaction. The market value of the securities on loan was \$32,971 and \$21,781 at June 30, 2008 and 2007, respectively.

(e) Inventory

Inventory is carried at the lower of cost or market value, determined using the first-in, first-out method.

(f) Property and Equipment

Property and equipment and other long-lived assets are recorded at cost when purchased or at fair market value if contributed. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Depreciation and amortization of assets are recorded on a straight-line basis over the period in which the assets are estimated to be in service and of value to the organization.

(g) Cost of Borrowing

Interest expense is recorded as incurred; however, when money is borrowed for construction or renovation of facilities, the interest cost on that debt during the period of construction is capitalized as part of the asset. Any interest income earned on borrowed funds during construction is accounted for as a reduction of interest cost. Costs associated with issuing debt are capitalized and amortized using a method that approximates the effective-interest method.

(h) Net Assets

Temporarily restricted net assets are those whose use by RCHHC has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity. Unrestricted net assets include those net assets whose use is not restricted by donors but whose use may be limited in other respects.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

(i) Performance Indicator

RCHHC considers excess of revenues over expenses to be RCHHC's performance indicator. Excess of revenues over expenses includes all changes in unrestricted net assets, except for unrealized gains (losses) on investments prior to June 30, 2008, third-party funding for property and equipment, net assets released from restrictions used for purchase of property and equipment, and pension-related changes other than net periodic pension cost.

(j) Reclassifications

Certain 2007 amounts have been reclassified to conform to the 2008 financial statement presentation.

(k) Contributions

Donations and bequests are reported at fair value at the date of the donation. Conditional promises to give are reported at fair value at the date the gift is received or the promise becomes unconditional. Gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of operations as net assets released from restrictions.

(l) Split-Interest Agreements

RCHHC participates in arrangements with donors in which RCHHC receives benefits that are shared with other beneficiaries. Under the terms of the remainder interest agreements, RCHHC receives distributions at the end of the agreement's term, generally upon the death of the other beneficiaries. In other agreements, RCHHC receives all the assets of the trusts, but is required to pay annuities to the other beneficiaries. These agreements are recorded based upon the fair market value of the trusts, discount rates ranging from 5% to 7% and assumed life expectancies. The remainder interest agreements are included in other long-term assets and total \$10,996 and \$11,753 at June 30, 2008 and 2007, respectively.

(m) Fundraising

The Foundation conducts all fundraising activities on behalf of RCHHC and its affiliates. During the years ended June 30, 2008 and 2007, restricted and unrestricted contributions totaled \$15,767 and \$21,648, respectively.

(n) Charity Care

RCHSD provides service without charge or at amounts less than its established rates to patients who meet certain criteria under its patient financial assistance and charity care policy. Because RCHSD does not pursue collection of amounts determined to qualify as charity care, these amounts are not reported as revenue. During the years ended June 30, 2008 and 2007, RCHSD's costs incurred for charity care totaled approximately \$5,675 and \$2,229, respectively.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

(o) *Income Taxes*

RCHHC is an organization exempt from taxation under Section 501(c)(3) of the Internal Revenue Code and Section 23701(d) of the California Revenue and Taxation Code and is generally not subject to federal or state income taxes. However, RCHHC is subject to income taxes on any net income that is derived from a trade or business, regularly carried on, and not in furtherance of the purpose for which it is granted exemption. No income tax provision has been recorded as the net income from any unrelated trade or business, in the opinion of management, is not material to the basic financial statements taken as a whole.

RCHHC accounts for income taxes related to the operations of its for-profit subsidiary (RCPMS) under the provisions of Statement of Financial Standards (SFAS) No. 109, *Accounting for Income Taxes*.

(p) *Recent Accounting Pronouncements*

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. FIN 48 seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. This interpretation became effective for RCHHC on July 1, 2007. Management evaluated the tax positions for each entity and determined that no material liabilities should be recorded.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. Management is evaluating the potential impact of SFAS No. 157, but does not expect SFAS No. 157 to have a material impact on the financial position, results of operations, or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115*. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. This statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Management is evaluating the potential impact of SFAS No. 159, but does not expect SFAS No. 159 to have a material impact on the financial position, results of operations, or cash flows.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

(3) Revenue

(a) Net Patient Revenue

RCHSD grants credit without collateral to its patients, most of whom are covered under third-party payor agreements. Gross patient revenue is recorded on the basis of usual and customary charges. Contractual allowances reflect the difference between gross patient revenue and payment amounts agreed to with third-party payors or stipulated by government payors. For the years ended June 30, 2008 and 2007, the following summary presents gross patient service charges by major payor classifications and contractual allowances recorded to arrive at net patient service revenue.

	2008	2007
Gross patient service charges:		
Medi-Cal/California Children's Services	\$ 528,287	473,074
HMOs and PPOs	394,579	350,889
TRICARE	47,354	44,719
Other	42,435	45,223
	<u>1,012,655</u>	<u>913,905</u>
Contractual allowances	<u>(645,333)</u>	<u>(588,620)</u>
Net patient service revenue	<u>\$ 367,322</u>	<u>325,285</u>

RCHSD has agreements with third-party payors that provide for payments to RCHSD at amounts different from its established charges. Payment arrangements include per diem payments, per discharge payments, reimbursed costs and discounted charges. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated settlements under reimbursement agreements with third-party payors. Settlements are accrued on an estimated basis in the period in which the related services are rendered and adjusted in future periods as final settlements are determined.

RCHSD has contracted with the State of California (the State) to provide acute hospital inpatient services to Medi-Cal beneficiaries at a negotiated rate per day. Either party may cancel this contract with 120 days' written notice. Outpatient services to Medi-Cal beneficiaries are reimbursed according to a State fee schedule. Convalescent hospital services are reimbursed by Medi-Cal based on prior years' costs, which are subject to audit by the State and subject to a cap.

All applicable Medi-Cal program cost reports for hospital services have been audited by the State of California through 2006.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

(b) *Premium Revenue*

RCHSD has agreements with several health maintenance organizations to provide pediatric health care services to enrollees. Under these agreements, RCHSD has negotiated monthly capitation payments based on the number of enrollees, regardless of services actually performed by RCHSD. RCHSD accrues the estimated cost of medical expenses provided to participants under these agreements for services rendered by providers other than RCHSD.

(c) *Grants and Contracts*

Advances received under various research grants and contracts are recorded as deferred revenue until the related research costs are incurred. RCHHC receives reimbursement for indirect costs on certain research grants and contracts based on a rate applied to direct costs. Direct and indirect costs reimbursed by United States government agencies are subject to audit by such agencies.

(d) *Physician Management Services Revenue*

Revenue from services provided by RCPMS to primary care physician practices represents payment for costs incurred in the management and operation of the practices and a management fee.

(e) *Other Government Revenue*

RCHSD qualifies for and receives funding from the State of California as a disproportionate share hospital (Senate Bill 855) for Medi-Cal. RCHSD also receives from the State of California supplemental funding for emergency services and patient care (Senate Bill 1100) and Presley funds (Senate Bill 1732) for the reimbursement of certain capital project financing costs. In addition, RCHSD participates in the Federal Graduate Medical Education Program, which provides funds to freestanding children's hospitals to support the training of pediatric and other residents.

Other government revenue for the years ended June 30, 2008 and 2007, includes the following:

	2008	2007
SB 1100 – Hospital supplemental payment program	\$ 17,900	17,900
SB 855 – Disproportionate Share Hospital (DSH) program	7,364	6,718
SB 1732 – Presley funds	1,122	2,455
Federal Graduate Medical Education	4,272	4,053
Other	75	313
Total other government revenue	\$ 30,733	31,439

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

(4) Community Benefit Expense

The following is a summary of RCHHC's community service for the years ended June 30, 2008 and 2007, in terms of services to the indigent and benefits to the broader community:

	2008	2007
Benefits for the indigent:		
Unpaid costs of the Medicaid/Medi-Cal program	\$ 39,536	44,954
Traditional charity care, at cost	5,675	2,229
Total quantifiable benefits for the indigent	45,211	47,183
Benefits for the broader community:		
Community service programs	16,135	13,994
Health, research, and education programs	491	495
Total quantifiable benefits for the broader community	16,626	14,489
Total quantifiable community benefits	\$ 61,837	61,672

(a) Benefits for the Indigent

Benefits for the indigent include services provided to persons who cannot afford healthcare because of inadequate resources or who are uninsured. This includes traditional charity care, at cost, and the costs in excess of government payments, of treating Medi-Cal beneficiaries.

Unpaid Costs of Medicaid/Medi-Cal Program

Unpaid costs of Medicaid/Medi-Cal program are the "shortfall" created when the facility receives payments below the costs of treating public program beneficiaries.

Traditional Charity Care

Traditional charity care results from RCHHC's policy to provide health care services free of charge or on a discounted fee schedule to individuals who meet certain financial criteria.

(b) Benefits for the Broader Community

Benefits for the broader community include services provided to needy populations that may not qualify as indigent but that need special services and support. This includes the costs of treatment in excess of government and beneficiary payments, community service programs, and health, research, and education programs.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

Community Service Programs

Community service programs are the net costs of providing social and health programs targeted for at-risk or underserved populations to improve the health of participants or involve the collaboration with community organizations. Also included are the net costs of delivering programs that provide community health education, healthcare support services, subsidized health services, community-building activities, support system enhancements, and services to maintain or improve the health of the community at large or specific populations.

Health, Research, and Education Programs

Health, research, and education programs include the net costs of programs that contribute to the knowledge and skill of health professionals at RCHHC and in the community. Research includes unreimbursed clinical and community health research, as well as clinical trials on therapeutic protocols and evaluation of innovative treatments, such as cardiology and cardiovascular surgery. Education includes the unreimbursed costs of training health professionals, such as medical residents, nursing students, and technicians.

(c) Total Quantifiable Community Benefits

Total quantifiable community benefits is the total cost incurred after deducting direct offsetting revenue from government reimbursement, patients, grants, and other sources. This net community benefit approximated 13% and 14% of RCHHC's total operating expenses for the years ended June 30, 2008 and 2007, respectively.

(5) Investments and Assets Limited as to Use

At June 30, 2008 and 2007, investments and assets limited as to use are summarized as follows:

	2008	2007
Investments and assets limited as to use:		
Cash and cash equivalents	\$ 171,381	119,640
Repurchase agreements	—	57,464
Common and preferred stocks	161,229	171,304
Corporate bonds	137,096	34,763
Alternative investments	20,385	6,583
Real assets and other	21,128	9,347
Less assets limited as to use	(161,952)	(63,091)
Less securities lent	(32,971)	(21,781)
Total investments	\$ 316,296	314,229

In connection with certain investments, RCHHC is committed to capital calls. The aggregate amount of these capital commitments was \$51,500 and \$34,500 at June 30, 2008 and 2007, of which \$21,794 and \$8,500 has been funded at June 30, 2008 and 2007, respectively.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

At June 30, 2008 and 2007, the composition of assets limited as to use is summarized as follows:

	<u>2008</u>	<u>2007</u>
Under indenture agreement, held by trustee (note 7)	\$ 160,260	57,723
Charitable gift annuities, held by trustee	1,016	1,335
Under capital lease agreement, held by trustee	—	158
State funding for property and equipment, held by RCHHC (note 12)	—	3,309
Executive compensation, held by trustee (note 9)	676	566
Total assets limited as to use	<u>\$ 161,952</u>	<u>63,091</u>

For the years ended June 30, 2008 and 2007, investment income is comprised of the following:

	<u>2008</u>	<u>2007</u>
Unrestricted:		
Interest and dividends	\$ 2,047	7,574
Net realized gains on investments	3,389	13,584
Interest, dividends and net realized gains on investments	5,436	21,158
Net unrealized gains (losses) on investments	(22,298)	11,939
Total	<u>\$ (16,862)</u>	<u>33,097</u>
Restricted:		
Interest and dividends	\$ 166	286
Net realized gains on investments	63	440
Net unrealized gains (losses) on investments	(630)	498
Total	<u>\$ (401)</u>	<u>1,224</u>

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

(6) Property and Equipment, Net

As of June 30, 2008 and 2007, property and equipment is summarized as follows:

	<u>Useful lives</u>	<u>2008</u>	<u>2007</u>
Buildings and improvements	5 – 40 years	\$ 198,353	165,054
Equipment	5 – 15 years	91,762	88,673
		<u>290,115</u>	<u>253,727</u>
Less accumulated depreciation		<u>(158,259)</u>	<u>(146,264)</u>
		131,856	107,463
Land		10,934	10,934
Construction in progress		54,434	36,572
Capitalized interest		2,231	421
Property and equipment, net		<u>\$ 199,455</u>	<u>155,390</u>

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

(7) Long-Term Debt

At June 30, 2008 and 2007, long-term debt is summarized as follows:

	<u>2008</u>	<u>2007</u>
Under the master trust indenture:		
Fixed Rate Insured Revenue Refunding Bonds, Series 2006A 4.00% to 5.00% serial and term bonds, payable in varying installments up to 2024; interest payable semiannually.	\$ 61,015	64,140
Fixed Rate Insured Revenue Refunding Bonds, Series 2006B 4.50% term bond, sinking fund payments due beginning in 2024 up to 2028; interest payable semiannually.	28,230	28,230
Variable Rate Insured Revenue Bonds, Series 2006C, due in varying installments up to 2036; interest payable weekly at a variable rate (weighted average of 4.48% and 3.62% for the years ended June 30, 2008 and 2007, respectively).	50,000	50,000
Variable Rate Insured Revenue Bonds, Series 2006D in varying installments up to 2041; interest payable weekly at a variable rate (weighted average of 4.26% and 3.63% for the years ended June 30, 2008 and 2007, respectively).	50,000	50,000
Variable Rate Insured Revenue Bonds, Series 2007A in varying installments up to 2047; interest payable weekly at a variable rate (weighted average of 4.78% for the year ended June 30, 2008).	62,500	—
Variable Rate Insured Revenue Bonds, Series 2007B in varying installments up to 2047; interest payable weekly at a variable rate (weighted average of 4.84% for the year ended June 30, 2008).	62,500	—
	<u>314,245</u>	<u>192,370</u>
Less:		
Premium, net of accumulated amortization	483	1,055
Current portion	<u>(2,680)</u>	<u>(3,125)</u>
Long-term debt	<u>\$ 312,048</u>	<u>190,300</u>

Based on the borrowing rates currently available to RCHHC for financing with similar terms and average maturities, the estimated fair value of long-term debt was \$311,198 and \$192,397 at June 30, 2008 and 2007, respectively.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

Scheduled repayment of principal at June 30, 2008 is as follows:

Fiscal years ending June 30:		
2009	\$	2,680
2010		2,790
2011		2,930
2012		3,045
2013		3,165
Thereafter		<u>299,635</u>
Total	\$	<u><u>314,245</u></u>

RCHSD is also subject to certain debt covenants under the indenture, including restrictions on additional indebtedness. The debt is collateralized by RCHSD revenues as defined in the indenture agreement.

In October 2006, pursuant to a financing plan, RCHHC issued \$192,370 of fixed and variable rate revenue bonds with various maturities through 2041. A portion of these proceeds was used to finance the acquisition, construction, equipping, and improvement of certain facilities owned and/or operated by RCHHC. The remainder of those proceeds was used to refund in advance \$93,280 of previously outstanding bond obligations and a capital lease. The debt has been legally defeased and, accordingly, the previously outstanding bond obligations and the assets placed in the trust are not included in the consolidated balance sheet as of June 30, 2008 and 2007. RCHHC recorded a loss on extinguishment of debt of \$2,772 during fiscal year 2007. RCHHC entered into a total return swap agreement in the amount of \$50,000 in connection with the Series 2006C variable interest rate bonds. RCHHC paid interest to the swap counterparty at the fixed rate of 3.628% and, in return, received interest at a variable rate equal to a percentage of one-month LIBOR.

In October 2007, pursuant to a financing plan, RCHHC issued \$125,000 of variable rate revenue bonds with various maturities through 2047. A portion of these proceeds was used to finance the acquisition, construction, equipping, and improvement of certain facilities owned and/or operated by RCHHC.

In November 2007, RCHHC entered into a total return swap agreement in the amount of \$125,000 in connection with the Series 2007A and Series 2007B variable interest rate bonds. RCHHC pays interest to the swap counterparty at the fixed rate of 3.371% and, in return, receives interest at a variable rate equal to a percentage of one-month LIBOR.

In December 2007, RCHHC entered into a total return swap agreement in the amount of \$50,000 in connection with the Series 2006D variable interest rate bonds. RCHHC pays interest to the swap counterparty at the fixed rate of 3.294% and, in return, receives interest at a variable rate equal to a percentage of one-month LIBOR. Both RCHHC and the counterparty have the right to terminate the arrangements prior to maturity.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

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(Dollars in thousands)

The estimated fair value of the total return swap instruments is determined using available market information and valuation methodologies, considering both discounted cash flows and the current market value of the variable interest rate bonds. These instruments have not been designated as a cash flow hedge and, therefore, the change in fair value for the years ended June 30, 2008 and 2007 is included in the excess of revenues over expenses in the accompanying consolidated statements of operations. The fair value of the total return swap instruments was recorded in the consolidated balance sheet at \$7,913 in liabilities at June 30, 2008 and \$1,887 in assets at June 30, 2007.

In March 2008, RCHHC recorded a \$5,827 other than temporary impairment of the unamortized bond insurance purchased in connection with the Series 2006C, 2006D, 2007A and 2007B auction rate debt, which represents the entire value of the policies. Management believes that the bond insurance is other than temporarily impaired due to recent and current market conditions. The primary intended purpose for purchasing the bond insurance was to enhance the underlying credit rating of the debt and achieve the lower interest rates.

The Series 2006C, 2006D, 2007A, and 2007B bonds are all currently issued as seven-day auction rate bonds. The interest rates on these bonds reset every seven days by the auction process. Should current bondholders desire to sell more bonds than bids received to purchase them, this would result in a failed auction. Failed auctions result in a reset of the interest rate for that issue at the failed auction rate (15%). A failed auction on these bonds does not result in a default or failure, but does result in higher interest costs.

Subsequent to June 30, 2008, RCHHC issued variable rate revenue bonds which were used to advance refund the outstanding balance of the Series 2006C, 2006D, 2007A and 2007B bonds (note 13).

RCHHC has a \$20,000 credit facility as of June 30, 2008 and 2007 which backs workers' compensation insurance policies and provides a working capital line of credit. Letters of credit against this facility totaled \$6,250 and \$8,400 for the years ended June 30, 2008 and 2007, respectively. These letters of credit were not drawn upon as of June 30, 2008 and 2007. In 2007, RCHHC was issued a \$5,000 sublimit under the credit facility to be available as a line of credit. In 2008, this line of credit sublimit was increased to \$10,000 and was not drawn upon.

(8) Temporarily and Permanently Restricted Net Assets

At June 30, 2008 and 2007, temporarily restricted net assets are available for the following purposes:

	2008	2007
Health care services and education	\$ 47,440	54,698
Capital projects	3,816	3,562
Total	\$ 51,256	58,260

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

During the years ended June 30, 2008 and 2007, temporarily restricted net assets were released from restrictions for the following purposes:

	<u>2008</u>	<u>2007</u>
Health care services and education	\$ 11,440	8,077
Capital projects	<u>3,239</u>	<u>1,512</u>
Total	<u>\$ 14,679</u>	<u>9,589</u>

Permanently restricted net assets of \$8,093 and \$7,233 at June 30, 2008 and 2007, respectively, represent investments to be held in perpetuity. The income from such net assets is restricted for the care of indigent patients or to support health care services.

(9) Employee Benefit Plans

(a) *Defined Benefit Plan*

RCHHC has a noncontributory defined benefit pension plan covering substantially all employees. A participating employee's annual post-retirement pension benefit is based on average compensation, years of service and Social Security benefits. RCHHC's funding policy is to contribute annually at least the required minimum amount as actuarially determined. RCHHC uses a June 30 measurement date for its defined benefit plan.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

The change in plan assets and the related change in benefit obligation as of and for the years ended June 30, 2008 and 2007, are presented as follows:

	2008	2007
Change in benefit obligation:		
Projected benefit obligation, beginning of year	\$ 81,097	73,061
Service cost	6,241	5,453
Interest cost	5,313	4,563
Actuarial gain/assumption change	(2,021)	(208)
Benefits paid	(2,001)	(1,907)
Administrative expenses paid	(87)	(91)
Plan change	50	226
Projected benefit obligation, end of year	88,592	81,097
Change in plan assets:		
Fair value of plan assets, beginning of year	82,845	63,841
Actuarial return on plan assets	(5,342)	9,502
Employer contributions	7,500	11,500
Benefits paid	(2,001)	(1,907)
Administrative expenses paid	(87)	(91)
Fair value of plan assets, end of year	82,915	82,845
Funded status	\$ (5,677)	1,748
Amounts recognized in the consolidated balance sheets consist of:		
Noncurrent assets	\$ —	1,748
Noncurrent liabilities	(5,677)	—
Accumulated charge to unrestricted net assets	15,919	6,771
Net amount recognized	\$ 10,242	8,519

The accumulated charge to unrestricted net assets as of June 30, 2008 represents charges arising from the defined benefit plan but not yet recognized as a component of net periodic benefit cost. The accumulated charge to unrestricted net assets at June 30, 2008 of \$15,919 is comprised of \$14,764 of unrecognized net actuarial losses and \$1,155 of unrecognized prior service cost. During fiscal year 2009, approximately \$618 is expected to be reclassified from the accumulated charge to unrestricted net assets to pension benefit cost.

The incremental effect of the adoption of SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* in fiscal year 2007 was a decrease in prepaid pension cost of \$6,771 with a corresponding decrease in unrestricted net assets.

The accumulated benefit obligation for the plan was \$60,876 and \$56,926 at June 30, 2008 and 2007, respectively.

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Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

For the years ended June 30, 2008 and 2007, the actuarially computed net periodic benefit cost includes the following components:

	<u>2008</u>	<u>2007</u>
Service cost	\$ 6,241	5,453
Interest cost	5,313	4,563
Expected return on plan assets	(6,112)	(4,739)
Net prior service cost amortization	159	141
Net loss amortization	162	298
Net periodic benefit cost	<u>\$ 5,763</u>	<u>5,716</u>

The plan's assumptions used to determine benefit obligations at June 30, 2008 and 2007, were as follows:

	<u>2008</u>	<u>2007</u>
Discount rate	6.75%	6.25%
Rate of compensation increase	5.00	5.00

The plan's assumptions used to determine net periodic pension cost for the years ended June 30, 2008 and 2007, were as follows:

	<u>2008</u>	<u>2007</u>
Discount rate	6.25%	6.25%
Expected long-term return on plan assets	7.50	7.50
Rate of compensation increase	5.00	5.00

The plan's expected future benefit payments at June 30, 2008 were as follows:

Fiscal years ending June 30:	
2009	\$ 2,871
2010	3,028
2011	3,330
2012	3,925
2013	4,577
2014 through 2018	32,629

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

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June 30, 2008 and 2007

(Dollars in thousands)

The basis used to determine the plan's overall expected long-term rate of return on assets has been the historical results of a balanced portfolio. The plan's investment strategy has been to diversify its portfolio between equity and debt investments, and to have its assets managed by third-party professionals. As of June 30, 2008 and 2007, the plan's assets by category are as follows:

	2008	2007
Equity securities	54%	59%
Debt securities	38	33
Other	8	8
	100%	100%

For the year ended June 30, 2009, there is no minimum funding requirement for the plan. RCHHC expects to contribute \$8,000 to the plan during the fiscal year ended June 30, 2009.

(b) *Deferred Compensation and Savings Plans*

RCHHC has a deferred compensation plan established for senior management. RCHHC also has a voluntary savings plan for selected management employees whereby RCHHC matches a certain percentage of the employees' savings. At June 30, 2008 and 2007, a liability related to these plans of \$3,849 and \$3,989, respectively, is included in accrued payroll and related benefits and other long-term liabilities. Included in assets limited as to use at June 30, 2008 and 2007, are \$676 and \$566, respectively, of investments which have been placed in a trust to fund a portion of this liability (see note 5). During the years ended June 30, 2008 and 2007, RCHHC incurred plan expenses of \$838 and \$952, respectively.

(c) *Children's Retirement Savings Plan*

RCHHC has a voluntary savings plan for all employees whereby RCHHC contributes from \$0.25 to \$0.65, based upon years of service, for each \$1.00 contributed by employees, up to 8% of each employee's salary. For the years ended June 30, 2008 and 2007, RCHHC's expense related to the match was \$3,145 and \$2,614, respectively.

(10) **Pledges Receivable**

RCHHC records pledges of greater than one year at their net present value, using risk-free interest rates applicable at the time of the contribution and the donor's expected payment terms ranging from 3.7% to 6.0%.

Pledge receivables are included in other receivables amounting to \$2,234 and \$5,245, respectively, and in other long-term assets amounting to \$31,280 and \$34,827, respectively, as of June 30, 2008 and 2007.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

Total unconditional pledges included in other receivables and other long-term assets at June 30, 2008, are receivable as follows:

Fiscal years ending June 30:		
2009	\$	2,234
2010		4,524
2011		3,799
2012		3,572
2013		3,424
Thereafter		38,112
Less present value discount		(22,151)
Total	\$	<u>33,514</u>

(11) Functional Expenses

RCHHC categorizes unrestricted operating expenses into two categories: health care services and general and administrative. Health care services include all expenses in departments that generate patient revenue. All other costs are referred to as general and administrative. For the years ended June 30, 2008 and 2007, the functional grouping of expenses is as follows:

	2008	2007
Health care services	\$ 329,502	300,558
General and administrative	143,666	136,974
Total	<u>\$ 473,168</u>	<u>437,532</u>

(12) Commitments and Contingencies

(a) Malpractice Coverage

RCHSD retained the first \$1,500 of liability per claim (retention) in both 2008 and 2007, for general and hospital professional liability. RCHSD's retention for 2008 and 2007 was limited by an annual policy-year aggregate of \$6,000 in each year for general and hospital professional liability. RCHSD purchases insurance for losses in excess of the RCHSD retention on a per-claim and aggregate basis. The provision for estimated medical malpractice claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

(b) Legal

RCHHC is a party to certain legal actions arising in the ordinary course of business. In the opinion of management, based upon current facts and circumstances known by RCHHC, resolution of these matters should not have a material adverse effect on RCHHC's consolidated financial statements.

During fiscal year 2006, unrelated arrests were made involving matters of sexual misconduct by two, now former, employees. RCHHC has insurance and insurance reserves to at least partially cover

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

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(Dollars in thousands)

such matters. At this time, no additional contingency is either probable or reasonably estimable; therefore, no additional liability has been recorded in accordance with SFAS No. 5, *Accounting for Contingencies*, in these financial statements as of June 30, 2008 and 2007.

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. Compliance with these laws and regulations can be subject to government review and interpretations, as well as regulatory actions unknown and unasserted at this time. Government activity has continued with respect to investigations and allegations concerning possible violations of regulations by health care providers that could result in the imposition of significant fines and penalties, as well as significant repayment of previously billed and collected revenues for patient services.

(c) *Leases*

RCHHC leases real property and equipment under noncancelable operating leases expiring at various dates through June 2017. Minimum future rental payments required by these leases at June 30, 2008, are as follows:

Fiscal years ending June 30:		
2009	\$	7,149
2010		6,729
2011		5,193
2012		2,643
2013		787
Thereafter		744
Total	\$	<u>23,245</u>

RCHHC's leases generally include annual escalation clauses and renewal options at the end of the lease term. Rental expense was \$9,271 and \$8,868 for the years ended June 30, 2008 and 2007, respectively.

(d) *State Funding for Property and Equipment*

In 2004, the State of California passed the Children's Hospitals Bond Act of 2004 (the Bond Act) whereby \$750,000 is being provided to improve and expand California children's hospitals, as well as to purchase new medical equipment for these hospitals. RCHSD is entitled to approximately \$74,000 from the Bond Act which will be recognized and reported as third-party funding for property and equipment in the accompanying consolidated statements of changes in net assets when qualifying expenditures are reimbursed in accordance with the Bond Act. As of June 30, 2008, approximately \$52,700 remains available to RCHSD.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

Funds paid to RCHHC for the years ended June 30, 2008 and 2007, were \$10,000 and \$3,309, respectively. During year ended June 30, 2008, \$13,303 of qualified expenditures were incurred and shown as third-party funding for property and equipment in the accompanying consolidated statements of operations. As of June 30, 2008 and 2007, respectively, \$0 and \$3,309 is included in assets limited as to use and advances of state funding for property and equipment in the accompanying consolidated balance sheets.

(e) Third-Party Funding for Property and Equipment

In 2007, RCHHC and Ronald McDonald House Charities of San Diego, Inc. (RMHC) entered into an agreement to jointly support the construction of a new, 47-bed Ronald McDonald House (the New House) to be located atop a new RCHHC parking structure. RMHC agreed to provide \$7,067 of funding to RCHHC for the additional construction costs resulting from the impact of placing the New House on the RCHHC new parking structure. RCHHC received \$5,652 and \$1,415 in funding from RMHC in the years ended June 30, 2008 and 2007, respectively, which is recorded as third-party funding for property and equipment in the accompanying consolidated statements of changes in net assets.

(f) Conditional Asset Retirement Obligation

RCHHC plans to renovate certain of its facilities in future years. Some of these facilities may contain asbestos or other hazardous materials which may require a future obligation to remove or encapsulate. In the opinion of management, the fair value of the obligation cannot be reasonably estimated, since sufficient information regarding the location and volume of any existing hazardous materials is not available or reasonably obtainable. Accordingly, RCHHC has not recognized a liability for the conditional asset retirement obligation.

(g) Seismic Compliance

California Senate Bill 1953 (SB 1953) requires hospital acute care buildings to meet more stringent seismic guidelines by 2008. RCHHC received an approval from the California Office of Statewide Health Planning and Development (OSHPD) for a time extension for compliance with SB 1953 until January 1, 2013. OSHPD recently revised its SB 1953 compliance standards and under these revised standards, it is expected that many acute care facilities in the State may be required to do less seismic retrofit. There can be no assurance, however, that the revised OSHPD standards will reduce RCHHC's percentage of noncompliant structures. The estimated cost to RCHHC of complying with SB 1953 is not currently determinable.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(Dollars in thousands)

(13) Subsequent Events

(a) *Bond Issuance*

In July 2008, RCHHC issued \$230,000 of variable rate revenue bonds payable in installments up to 2047. A portion of the bond proceeds were placed in an irrevocable trust and, pursuant to an escrow agreement, were used to purchase government securities to advance refund the outstanding balance of the Series 2006C, 2006D, 2007A and 2007B bonds in the amount of \$225,000. Based on the terms of the trust and escrow agreements, the debt is considered to have been legally defeased and, accordingly, the previously outstanding bonds and trust assets will be removed from the consolidated balance sheet. RCHHC terminated the total return swap agreements for the Series 2006D and the 2007 Bonds. The total amount of the termination payments was \$5,795. The remaining bond proceeds financed bond issuance costs of \$2,109 and a portion of the swap termination payments. In July 2008, RCHHC recorded a loss on early extinguishment of debt of \$2,165.

(b) *Market Conditions*

Since June 30, 2008, U.S. and world markets have experienced significant declines. Management is monitoring investment market conditions and the impact such declines are having on RCHHC's investment portfolio. Due to the volatility of the financial markets as of the date of this report, there is uncertainty regarding the impact which continued volatility may have on RCHHC's investment portfolio.



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**Report on Internal Control over Financial Reporting and on
Compliance and Other Matters Based on an Audit of
Financial Statements Performed in Accordance With
*Government Auditing Standards***

The Board of Trustees
Rady Children's Hospital and Health Center:

We have audited the consolidated financial statements of Rady Children's Hospital and Health Center and subsidiaries (the Company) as of and for the year ended June 30, 2008, and have issued our report thereon dated September 18, 2008, except for note 13(b), which is as of November 20, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Company's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control over financial reporting. We consider the deficiencies described as finding 08-01 and finding 08-02 in the accompanying schedule of findings and questioned costs to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be

material weaknesses. However, of the significant deficiencies described above, we consider the deficiency described as finding 08-02 in the accompanying schedule of findings and questioned costs to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Company's consolidated financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The Company's response to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit the Company's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, the board of trustees, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

September 18, 2008



KPMG LLP
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**Report on Compliance with Requirements Applicable to
Each Major Program and on Internal Control over
Compliance in Accordance with OMB Circular A-133**

The Board of Trustees
Rady Children's Hospital and Health Center:

Compliance

We have audited the compliance of Rady Children's Hospital and Health Center (the Company) with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2008. The Company's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Company's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the Company's compliance with those requirements.

In our opinion, the Company complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2008.

Internal Control over Compliance

The management of the Company is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Company's internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below.

A control deficiency in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

Schedule of Expenditures of Federal Awards

We have audited the consolidated financial statements of the Company as of and for the year ended June 30, 2008, and have issued our report thereon dated September 18, 2008, except for note 13(b), which is as of November 20, 2008. Our audit was performed for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and the accompanying schedules of status of cash, statement of approved budget and cumulative expenditures, and statement of costs claimed and accepted are presented for additional analysis as required by the California Governor's Office of Emergency Services and are not a required part of the consolidated financial statements. Such information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole.

This report is intended solely for the information and use of the board of trustees, management, others within the Company, federal and state awarding agencies, and pass-through entities, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 20, 2008, except as to
the schedule of expenditures of
federal awards, which is
as of September 18, 2008.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Schedule of Expenditures of Federal Awards

Year ended June 30, 2008

Program title/ federal or state grantor/ pass-through grantor	CFDA number or other identifying number	Grant or contract number	Expenditures
Research and Development:			
Department of Health and Human Services:			
National Institutes of Health – National Institute of Mental Health Direct Programs			\$ 884,533
Passed through other organizations:			
Washington University	93.242	R01 MH74497	293,562
Washington University	93	N01 HD63421	101,752
Children's Hospital and Regional Medical Center – Seattle	93.846	R01 AR049762	17,396
University of Pennsylvania	93.242	R01 MH077000	17,448
National Cancer Institute	93.395	U10 CA98543	29,726
University of California, San Diego	93.837	R01 HL69413	203,849
University of California, San Diego	93.242	R01 MH39434	7,312
University of California, San Diego	93	N01 AI15416	10,379
University of California, San Diego	93.397	P30 CA023100	11,919
University of California, San Diego	93.242	R01 MH072961	52,054
University of California, San Diego	93.242	P50 MH081755	20,676
Massachusetts General Hospital	93.855	U01 AI067693	9,390
Baylor College of Medicine	93.389	U54 RR19478	58,189
Oregon Social Learning Center	93.865	R01 HD45894	25,215
Substance Abuse and Mental Health Service Administration (SAMHSA)			
Passed through other organizations:			
Mental Health Systems, Inc.	93.243	R01 HD14333	22,575
Health Resources and Services Administration:			
Maternal and Child Health Bureau:			
Passed through RAND:			
Reducing Barriers for Vulnerable Children with Asthma	93.110	R40 MC01214	79,365
Passed through Children's Hospital of Orange County:			
MCHB Hemophilia Grant	93.110	5H30MC00036-10	13,258
Department of Education:			
Office of Special Education and Rehabilitative Services:			
Special Education – Research and Innovation to Improve Services and Results for Children with Disabilities	84.324	R32 B070027	232,433
			1,206,498
Total research and development			2,091,031

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Schedule of Expenditures of Federal Awards

Year ended June 30, 2008

Program title/ federal or state grantor/ pass-through grantor	CFDA number or other identifying number	Grant or contract number	Expenditures
Other Programs:			
Department of Health and Human Services:			
Administration for Children and Families:			
Passed through County of San Diego:			
Cal Works Injury Prevention	93.569	516404	\$ 35,000
Passed through County of San Diego:			
HRSA Disaster Preparedness Grant	93.569	507805	25,100
Passed through County of San Diego:			
Injury Prevention and Disaster Preparedness	93.569	524237	10,491
Passed through County of San Diego:			
Foster Parent Training OPT	93.658	45869	17,354
Passed through the California Governor's Office of Emergency Services:			
Extended Forensic Evaluation	93.643	EF07021139	37,972
Passed through State of California Office of Child Abuse Prevention:			
Clearing House Evidence – Office of Child Abuse Prevention	93.556	EBC 30001/00-A2	223,261
Clearing House Evidence – Office of Child Abuse Prevention	93.669	EBC 30001/00-A2	189,946
Passed through University of California, Davis:			
CCFMTTC – University of California, Davis Subcontract	93.643	UCD08-05069	35,656
Passed through University of San Diego:			
OES/USD Training Grant	93.643	LC06018564	10,843
Office of Population Affairs:			
Direct program – Reaching Adolescent Pregnancy	93.995	4-APHPA002086-05-02	50,758
Centers for Disease Control:			
Passed through Children's Hospital of Orange County:			
CDC Hemophilia Grant	93.283	U01DD000204-02	60,706
Passed through Children's Hospital of Orange County:			
Diamond Blackfan Anemia Project	93.283	U27/CCU916521-08-01	654

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Schedule of Expenditures of Federal Awards

Year ended June 30, 2008

Program title/ federal or state grantor/ pass-through grantor	CFDA number or other identifying number	Grant or contract number	Expenditures
Health Resources and Services Administration: Passed through the County of San Diego: HRSA Disaster Preparedness Grant	93.889	507805	\$ 260,308
SAMHSA			
Direct program:			
SAMHSA Grant	93.243	5U79SM054289-06	579,775
SAMHSA Conference Support Grant	93.243	1H13SM057895-01	50,000
Passed through University of Los Angeles: NCTSN Mini Grant	93.243	U79SM54284	2,005
Department of Justice:			
Office of Victims of Crime:			
Passed through the California Governor's Office of Emergency Services:			
Child Abuse Treatment Program (C.H.A.T)	16.575	AT07041139	230,477
Office of Juvenile Justice and Delinquency Prevention:			
Passed through National Children's Alliance:			
NCA Conference Grant	16.543	SanD-CA-PS08	11,197
Passed through RAND:			
Safe Start Evaluation - TX Group	16.730	9920060081	18,779
Passed through County of San Diego:			
Safe Start Data Collection and Management Services	16.730	516843	10,026
Passed through DB Consulting Group, Inc:			
San Diego Conference Support	16	2006C_012	25,000
Violence Against Women Office:			
Passed through San Diego Volunteer Lawyer:			
San Diego Volunteer Lawyer	16.524	2005-WL-AX-0042	35,536
Department of Education:			
Office of Elementary and Secondary Education:			
Passed through San Diego Unified School District:			
Safe Schools/Healthy Students Evaluation	84.184	S184L010009	406
Department of Transportation:			
National Highway Traffic Safety Administration:			
Passed through University of San Diego:			
Crash Investigation & Research & Engineering Network	20.600	10267794	1,000

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Schedule of Expenditures of Federal Awards

Year ended June 30, 2008

Program title/ federal or state grantor/ pass-through grantor	CFDA number or other identifying number	Grant or contract number	Expenditures
Programs Containing Multiple Funding Sources (note 5):			
California Health and Human Services Agency:			
Direct Program:			
High Risk Infant Follow-Up Program	99	06-55258	\$ 29,772
Passed through San Diego Regional Center:			
Main Toddler School	99	H85690	93,126
Passed through County of San Diego:			
Foster Parent Training OPT	99	45869	2,897
California Department of Health Services:			
Direct Program:			
Newborn Screening Program	99	06-55827	201,162
California Department of Education:			
Passed through School Districts:			
School Health Contract	99		58,240
School Health Screening	99		40,739
California Governor's Office of Emergency Services:			
Direct Program – Victims of Crime Act:			
Vista Child Sexual Abuse Treatment	99	CS07031139	15,078
Passed through University of California, Davis:			
CCFMTC – UC Davis Subcontract	99	UCS08-05069	9,984
Total other programs			<u>2,373,248</u>
Total expenditures of federal awards			<u>\$ 4,464,279</u>

See accompanying notes to Schedule of Expenditures of Federal Awards.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Notes to Schedule of Expenditures of Federal Awards

June 30, 2008

(1) General

The accompanying schedule of expenditures of federal awards presents the activity of all federal financial assistance programs of Rady Children's Hospital and Health Center (RCHHC). RCHHC's reporting entity is defined in note 1 to the consolidated financial statements. Federal financial assistance received directly from federal agencies as well as federal financial assistance passed through other government agencies is included in the schedule.

(2) Basis of Accounting

The accompanying schedule of expenditures of federal awards is presented using the accrual basis of accounting as described in note 2 to the consolidated financial statements of RCHHC as of and for the year ended June 30, 2008.

Because the schedule of expenditures of federal awards presents only a selected portion of the activities of RCHHC, it is not intended to and does not present either the financial position or changes in net assets of RCHHC.

(3) Relationship to Federal Financial Reports

Amounts reported in the accompanying schedule of expenditures of federal awards agree, in all material respects, with the amounts reported in related federal financial reports.

(4) Funds Provided to Subrecipients

Included in direct program expenditures of funds received from the U.S. Department of Health and Human Services and the U.S. Department of Education are \$433,837 and \$29,853, respectively, of funds provided to subrecipients under the research and development program.

(5) Programs Containing Multiple Funding Sources

Program expenditures may include funding that originates from a combination of sources, including federal and state governments. For some of these programs, funding is provided from a specific source; whereas for others, funding is provided from multiple sources. Total federal expenditures for these programs have been presented in the schedule of expenditures of federal awards and have been determined by applying an estimated rate of 28% on total funds received from the State of California.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Schedule of Findings and Questioned Costs

June 30, 2008

(1) Summary of Auditor's Results

Consolidated Financial Statements

Type of auditor's report issued: *Unqualified opinion.*

Internal control over financial reporting:

- Material weaknesses identified X Yes No
- Significant deficiencies in internal control were disclosed by the audit of the consolidated financial statements X Yes None reported

Noncompliance material to financial statements noted? Yes X No

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? Yes X No
- Significant deficiencies in internal control over major programs Yes X None reported

Type of auditor's report issued on compliance for major programs: *Unqualified opinion.*

Any Audit Findings which are required to be reported in accordance with Section 510(a) of OMB Circular A-133

 Yes X No

Identification of major programs:

CFDA No.	Federal program name
Various 93.243	Research and Development Cluster Substance Abuse and Mental Health Services Administration

Dollar threshold used to distinguish between type A and type B programs:

\$300,000

Auditee qualified as low-risk auditee?

 Yes X No

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Schedule of Findings and Questioned Costs

June 30, 2008

(2) Findings Relating to the Financial Statements Reported in Accordance with *Government Auditing Standards*

08-01 – Valuation of Certain Investments

Criteria or Requirement

Accounting principles generally accepted in the United States of America require that Rady Children's Hospital and Health Center's (RCHHC's) investments be reported at fair value.

Condition Found, Including Perspective

RCHHC records the value of the investments as reported by the custodian during each period end. The majority of the investments held by the custodian are marketable debt and equity securities with readily determinable fair values (i.e. based on quoted market prices). The values of investments without readily determinable fair values such as investments in limited partnerships, limited liability corporations, or other institutional funds, recorded by the custodian are based on statements received from the individual fund managers; however, in certain circumstances the statements recorded by the custodian do not represent the most recent fair value available. This results from the custodian not receiving the most recent fair value information prior to their production of period end reports.

In addition to the custodian, the fund managers provide statements to RCHHC's investment advisor. We obtained the June 2008 report from RCHHC's investment advisor, which reported the fair value of RCHHC's investments without readily determinable fair values. When comparing the values as of June 30, 2008 in the investment advisor report to the value recorded in the general ledger, we identified discrepancies that resulted in an adjustment to decrease the value of investments by \$5.2 million and another \$0.7 million decrease in the value of investments held by RCHHC's pension plan.

Possible Asserted Cause and Effect

Prior to June 30, 2008, RCHHC had designed a control of reconciling the value of these investments in the investment advisor report to the value reported by the custodian and recorded in the general ledger. This control was not operating effectively at June 30, 2008.

Recommendation

RCHHC should fully implement the control that was designed to identify the differences in value of these investments as recorded in the general ledger compared to the investment advisor report.

Views of Responsible Officials and Planned Corrective Action

RCHHC will consistently reconcile the custodian and fund manager reports each month, in order to mitigate the risk that the custodian's reports may not reflect current fund valuations.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Schedule of Findings and Questioned Costs

June 30, 2008

08-02 – Errors in Key Spreadsheets

Criteria or Requirement

Spreadsheets used in financial reporting should be reviewed for accuracy.

Condition Found, Including Perspective

We identified a formula error within a spreadsheet used in the determination of the allowance for bad debts that resulted in an overstatement of the allowance for bad debts of \$1.8 million.

Possible Asserted Cause and Effect

The spreadsheet had been reviewed by someone other than the preparer; however, the level of review conducted was not sufficient to detect the error.

Recommendation

RCHHC should strengthen the controls over the review of spreadsheets so that errors of a more than inconsequential nature would be detected.

Views of Responsible Officials and Planned Corrective Action

RCHHC will implement procedures to increase the level of review by including additional testing of the underlying formulas in key spreadsheets. An inventory of key spreadsheets that support and/or impact financial reporting will be performed and a procedure will be created that requires the review and sign-off of the formulas and spreadsheets by the preparer, a second individual not materially involved with the particular spreadsheets, and a management level employee.

(3) Findings and Questioned Costs Relating to Federal Awards

None.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Statement of Approved Budget and Cumulative Expenditures

Year ended June 30, 2008

	<u>Budget</u>	<u>Cumulative expenditures claimed</u>	<u>Variance</u>
Grant No. CS07031139:			
Personal services	\$ 41,837	42,468	(631)
Operating expenses	9,463	11,136	(1,673)
Equipment	—	—	—
Total	<u>\$ 51,300</u>	<u>53,604</u>	<u>(2,304)</u>
Grant No. AT07041139:			
Personal services	\$ 180,642	182,664	(2,022)
Operating expenses	19,358	28,445	(9,087)
Equipment	—	19,368	(19,368)
Total	<u>\$ 200,000</u>	<u>230,477</u>	<u>(30,477)</u>
Grant No. EF07021139:			
Personal services	\$ 31,843	28,415	3,428
Operating expenses	18,157	9,557	8,600
Equipment	—	—	—
Total	<u>\$ 50,000</u>	<u>37,972</u>	<u>12,028</u>

See accompanying note to program schedules.

RADY CHILDREN'S HOSPITAL AND HEALTH CENTER

Note to Program Schedules

June 30, 2008

(1) Summary of Significant Accounting Policies

The program schedules, Schedules A, B and C, have been reported from the grant budgets approved by the California Governor's Office of Emergency Services (OES), the Reports of Expenditures and Request for Funds (Form 201), and the records of Rady Children's Hospital and Health Center (RCHHC).

Form 201 was prepared by RCHHC personnel in accordance with OES requirements. The basis of accounting used in preparing Form 201 may differ from accounting principles generally accepted in the United States of America. Accordingly, the accompanying program schedules are not intended to present the financial position and results of operations in conformity with accounting principles generally accepted in the United States of America.